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TAGS: ECON EFIN NZ
SUBJECT: NEW ZEALAND GOVERNMENT UNVEILS CAUTIOUS BUDGET

REF: A. WELLINGTON 344 (NOTAL)
¶B. CANBERRA 697 (NOTAL)
¶C. 2004 WELLINGTON 849 (NOTAL)

(U) Sensitive but unclassified - protect accordingly.

¶1. (SBU) Summary: New Zealand's Labour government maintained its image for tightfistedness by delivering a 2006-7 budget with an anticipated surplus and no tax relief. Most of the government's new spending will go to the health sector and road improvements and deliver on Labour's 2005 campaign promises, including increased welfare and interest-free student loans. Demands for even bigger budget spending may grow louder, however, as New Zealand faces an economic slowdown this year, following five years of strong growth. Economists view the budget as fiscally sound and unlikely to affect New Zealand's relatively high interest rates or the value of its dollar, which the government has been talking down in hopes of spurring exports. But the budget does little to improve New Zealand's lagging competitiveness. It also was immediately denounced by the opposition for lacking Australian-style tax cuts despite the big surplus. End summary.

An equitably sliced pie

¶2. (U) In his seventh budget since Labour regained power, Finance Minister Cullen on May 18 announced a NZ $52.3 billion (US $32.5 billion, NZD 1.00 = USD .6221) spending plan for 2006-7, a 3.5 percent increase from the current fiscal year. It includes NZ $2.2 billion in new spending, a small rise from the $2 billion in new spending provided in the current budget.

¶3. (SBU) The budget reflects Labour's philosophy of redistributing income to ensure a "fairer society," with the public sector providing a social safety net. The largest outlay of new capital spending -- NZ $1.3 billion over five years -- is to cover the rising costs of road building and to speed up completion of major highway projects. For the first time, the government will be spending more on roads than it collects in gas taxes and vehicle registration fees, according to Cullen. The health sector -- which accounts for 21 percent of all government outlays -- will receive a NZ $750 million injection of new spending in each of the next four years, raising its annual expenditure to NZ $10.6 billion (an 8.5 percent rise from the current year). Next year's increase in new health spending will be a slightly

smaller boost than the current year's.

¶4. (SBU) The budget's other big-ticket items fulfill the Labour Party's campaign promises from the September 2005 election: More low- to middle-income families will receive support payments (called "tax relief" by the government) at a cost of NZ $1.85 billion over the next four years. The budget also allocates NZ $1 billion over the next four years to pay for interest-free student loans.

¶5. (U) Deals hammered out with Labour's support parties also increased appropriations, including spending for the hiring of 1,000 more police, as promised to Winston Peters, foreign minister and the leader of New Zealand First. As a result of Labour's agreement with United Future leader Peter Dunne (and now minister of revenue), he and Cullen are preparing a review of business taxation, with likely reductions expected to be introduced in April 2008.

¶6. (U) There are no immediate tax cuts, either for businesses or individuals, despite a NZ $8.5 billion operating surplus (equivalent to 5.4 percent of GDP) forecast for the fiscal year ending June 2006. Cullen has designated some of the surplus to cover capital expenditures and contributions to the Superannuation Fund, to pre-fund a public pension plan that is expected to reach NZ $10 billion in assets this year. Cullen cited a desire to prepare New Zealand to care for an aging population and an anticipated economic slowdown as reasons why there was no room for tax cuts. The budget surplus is expected to drop to NZ $5.8 billion in 2006-7 after accumulating over the previous five years.

Still no tax cuts

¶7. (U) Hoping to draw attention to Australia's recently proposed income tax cuts (ref B), the opposition National Party labeled the New Zealand government's plan a "Bondi budget" in reference to the famous Sydney beach. National argued that the lack of tax relief will accelerate an existing brain drain from New Zealanders moving to Australia. An estimated net 20,400 New Zealanders left for Australia in the year to April 2006. The Labour government's resistance to tax relief was an issue in last year's election campaign and almost cost it the election. New Zealand's top tax rate is 39 percent, applied on the incomes of the 12 percent of New Zealanders who earn more than NZ $60,000 a year (about US $37,000). Only 5 percent of taxpayers paid the higher rate when it was enacted by the Labour-led government in 2000. The New Zealand Inland Revenue Department predicts that increased government revenues may allow for tax cuts before the 2008 election.

¶8. (U) Meanwhile, the New Zealand Treasury is forecasting that economic growth will slow to about one percent in the year to March 2007 -- a sharper downturn than Treasury predicted six months ago (ref C) -- due largely to the previously high New Zealand dollar, higher interest rates and gas prices and, hence, slower consumer spending. The downturn gives Cullen justification for years of fiscal conservatism: Having stockpiled surpluses during five years of economic expansion, his government now can afford to boost spending as the economic clouds darken. "The fool who spends on the upturn will find himself broke on the downturn," Cullen told Parliament. Since 2000, real GDP growth has averaged 3.6 percent annually, with a peak performance of 4.8 percent in 2004. Treasury expects growth to rebound in the year to March 2008 to more than 3 percent as the New Zealand dollar dips in value and spurs agricultural exports.

¶9. (SBU) Economists see the 2006-7 budget as cautious and adding little stimulus to the economy. The government can increase spending because of the operating budget surplus and low government debt relative to GDP. Gross debt is expected to fall to 23 percent of GDP by June 2006, down from a level

of more than 60 percent of GDP in the early 1990s. The net debt level -- the government's financial assets offset by the gross debt -- should drop to 6.7 percent of GDP. When the government's pension fund is included, its financial assets exceed its liabilities.

For defense and foreign aid

¶10. (U) The budget sets aside NZ $72.8 million in new funding for defense operating expenses, as the second installment in the government's 10-year, NZ $4.6 billion program to modernize New Zealand's defense infrastructure and increase its military personnel. The budget also allocates an additional NZ $305 million for defense hardware for the next fiscal year, the third installment of a 10-year, NZ $3 billion capital replacement and upgrade project. The defense appropriations for 2006-7, including the new spending, are equivalent to about one percent of GDP and compose about 2.5 percent of all government appropriations. Septel will look at the defense budget in greater detail.

¶11. (U) Official development assistance remains at 0.27 percent of GNI this year but rises to 0.28 percent in 2007-8, with assistance totaling NZ $1.4 billion over the next four years.

Comment

¶12. (SBU) Clouds forming over a fair-weather economy are giving the government some cover, as it keeps a tight rein on spending and refuses to countenance tax cuts -- even in the face of continuing budget surpluses. Proceeding cautiously to ensure economic and political stability, Labour also is playing to its core constituents with increases in social spending. However, the tax-cut debate continues, and National's dire warnings that more New Zealanders may vote with their feet -- to Australia -- still could get traction. The budget also does little to address New Zealand's lagging competitiveness or long-term economic growth. More spending on the health sector, welfare and student loans

redistributes, rather than creates, national wealth. Still to be seen is whether a possible 2008 cut in the business tax will prompt businesses to boost capital investment and raise productivity, which holds the key to New Zealand's long-term economic growth.

Budget forecast

¶13. (U) Annual avg pct change, year ending March 31, unless otherwise indicated

	Actual 2005		Est. 2006	2007	Forecast 2008	2009	2010
Consumption 5.7	4.3	1.8		1.1	2.3	2.5	
--public (1)	5.2	5.9	5.6		2.2	3.9	3.4
--private	5.8	3.8	0.7		0.8	1.9	2.3
Investment 7.8	6.0	-4.6		-0.2	4.8	4.6	
Exports	3.9	0.1	1.0		5.6	5.0	3.8
Imports	13.7	5.1	-1.0		-0.9	3.4	3.7
GDP	3.7	2.1	1.0		3.3	3.5	3.1
Unemployment(2)3.9		3.8	4.7		4.7	4.4	4.5
CPI inflation(3)2.8		3.3	3.4		2.4	2.0	2.0
Current account							
--NZD million -11062-14462-13925-12188-11383-11035							
--pct of GDP	-7.4	-9.3	-8.8	-7.3	-6.5	-6.0	
90-day bank bill rate (4)	6.9	7.6	7.0	6.3	6.0	5.8	

Spending (5)						
--NZD million	46234	50445	52254	55158	57973	60527
--pct of GDP	30.6	31.9	31.8	32.6	32.5	32.4
Revenue (5)						
--NZD million	52065	56652	56190	57781	59728	64157
--pct of GDP	34.5	34.2	34.4	33.9	33.3	34.1
Operating Balance (6)						
--NZD million	6247	8486	5768	4343	3561	5412
--pct of GDP	4.1	5.4	3.6	2.6	2.0	2.9
Superannuation Fund (6)						
--end year						
NZD million	6555	10015	12739	15826	19335	23251
--pct of GDP	4.3	6.4	8.0	9.4	10.8	12.4

(1) Forecast for public consumption is influenced by government defense spending.
(2) Rate in March quarter, seasonally adjusted.
(3) Annual percentage change.
(4) Average for March quarter.
(5) Core Crown accounts; excludes some items such as Crown entities and state-owned enterprises. For year ending June ¶30.
(6) For year ending June 30.
McCormick